TAXATION AND REVENUE: Liability of employees of Federal Reserve Banks for Missouri Income Taxes.

May 5, 1937.

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Hon. Forrest Smith,
State Auditor,
Jefferson City, Mo.

Dear Sir:

A request for an opinion has been received from you under date of April 19, 1937, such request being in the following terms:

> "I would like an opinion from your office as to whether or not the compensation received by employees of the Federal Reserve Banks is exempt from Missouri income tax."

R. S. Mo. 1929, sec. 10119, provides in part as follows:

> "The following income shall be exempt from the provisions of this article. * * * (5) The compensation of public officers for public service where the taxation thereof would be repugnant to the constitution * * *."

The question which you have asked, therefore, raises the question of whether the United States Constitution or any federal statute prohibits the imposition of the tax in question, since the Missouri statute above quoted leaves it to federal law to decide if this income is exempt, and the Missouri statute only purports to follow the federal law. In other words, if federal law does not prohibit the tax, it is levied by the Missouri statute, as such a tax would not be repugnant to the Missouri Constitution or other Missouri statutes.

There is a federal statute on tax exemption of Federal Reserve Banks, which provides as follows:

> "Federal reserve banks, including the capital stock and surplus therein, and the income derived therefrom shall be exempt from Federal, State and local taxation, except taxes upon real estate." (December 23, 1913, c.6, sec. 7, 38 Stat. 258; March 3, 1919, c.101, sec. 1, 40 Stat. 1314; 12 U.S.C.A., sec. 531.)

It might be noted in passing that R. S. Mo. 1929, sec. 10119, quoted above, only exempts compensation of "public officers for public service", and only in such cases where it would be repugnant to the constitution, and says nothing about repugnance to any federal statute. However, in our opinion, this federal statute cannot be controlling for reasons which will appear more fully below. If the State of Missouri is not prohibited by the Constitution of the United States or by its organic law from assessing this tax, Congress cannot take away the state's power to impose it, and if the tax is prohibited by the Constitution of the United States, the federal statute is unnecessary.

This leaves for consideration the nature and functions of Federal Reserve Banks and their relationship to the Government of the United States, in order that it may be determined whether they are so closely related to that government, and such essentially governmental instrumentalities, that the income of their employees is withdrawn by the Constitution of the United States from taxation by the State of Missouri.

I.

FEDERAL RESERVE BANKS.

The Federal Reserve Banks were originally created by an Act of December 23, 1913, known as the "Federal Reserve Act", 38 Stat. 251. The major amendments have been made by an Act of June 16, 1933, known as the "Banking Act of 1933", 48 Stat. 162, and an Act of August 23, 1935, known as the "Banking Act of 1935", 49 Stat. 684. These statutory provisions are found in Vol. 12 of the U.S. Code Ann., pp. 466 et seq. They are so voluminous that we deem it advisable to offer only a brief synopsis of them.

There are twelve Federal Reserve Banks in this country, of which two are in Missouri, and each Federal Reserve Bank has member banks located in its district, including all national banks therein and certain state banks. The capital of the Federal Reserve Banks is provided by member banks who subscribe for shares to the extent of 6% of their own capital and surplus, which shares pay dividends at the rate of 6%. Dividends earned by the Federal Reserve Banks in excess of 6% are added to the surplus of the Federal Reserve Banks.

Among the functions of the Federal Reserve Banks are the following: 1. Acting as depositaries of the reserves which their member banks are required to maintain, these reserves consisting of certain percentages of deposit liabilities of member banks fixed within statutory limits by the Federal Reserve Board. 2. Making loans and discounts for member banks, with the interest and discount rates subject to review and determination by the Federal Reserve Board. 3. Acting as fiscal agents and depositories of the United States Treasury, performing services such as paying government checks, taking subscriptions for government bonds, redeeming government bonds, etc. 4. Issuing federal reserve notes which are legal tender, such notes constituting about two-thirds of the circulating currency of the country (Fed. Res. Bulletin 1936, p. 989).

Each Federal Reserve Bank is governed by a Board of Directors, six of whom are chosen by member banks and the other three by the Federal Reserve Board, which consists of seven members appointed by the President of the United States and which exercises a general supervisory control over the Federal Reserve Banks.

The foregoing does not purport to be a complete description of the Federal Reserve System, but it should be sufficient to serve as a basis for this opinion.

II.

INTER-GOVERNMENTAL EXEMPTION FROM TAXATION OF CERTAIN STATE AND FEDERAL INSTRUMENTALITIES.

There was established, in the case of McCulloch v. Maryland, 4 Wheat. 316 (1819), the principle that it is a necessary correlary to our dual system of government that one government should be free, in the exercise of its governmental functions, from tax burdens imposed by the other government. There is no specific provision in the constitution to this effect, but Chief Justice Marshall deduced it from the four corners of the Constitution of the United States.

> "It is an established principle of our constitutional system of dual government that the instrumentalities, means and operations whereby the United States exercises its governmental powers are exempt from taxation by the states, and that the instrumentalities, means and operations whereby the states exert the governmental powers belonging to them

> are equally exempt from taxation by the United States. This principle is implied from the independence of the national and state governments within their respective spheres and from the provisions of the Constitution which look to the maintenance of the dual system. Collector v. Day (Buffington v. Day) 11 Wall. 113, 125, 127, 20 L.ed. 122, 126, 127; Willcutts v. Bunn, 282 U.S. 216, 224, 225, ante, 304, 306, 71 A.L.R. 1260, S.Ct.125. Where the principle applies it is not affected by the amount of the particular tax or the extent of the resulting interference, but is absolute. M'Culloch v. Maryland, 4 Wheat. 316, 430, 4 L.ed. 579, 607; United States v. Baltimore & O.R.Co. 17 Wall. 322, 327, 21 L.ed. 597, 599; Johnson v. Maryland, 254 U.S. 51, 55, 56, 65 L.ed. 126, 128, 129, 41 S. Ct. 16; Gillespie v. Oklahoma, 257 U.S. 501, 505, 66 L.ed. 338, 340, 42 S.Ct. 171; Crandall v. Nevada, 6 Wall. 35, 44-46, 18 L.ed. 745, 747, 748.
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> "Of course, the reasons underlying the principle mark the limits of its range. Thus * * * it * * has been held where a state departs from her usual governmental functions and 'engages in a business which is of a private nature' no immunity arises in respect of her own or her agents' operations in that business. South Carolina v. United States, 199 U. S. 437 (1905), 50 L.ed. 261, 26 S.Ct. 110, 4 Ann.Cas. 737."
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> Indian Motocycle Co. v. U.S., 283 U.S. 570, 575, 576 (1931).

The case of South Carolina v. United States, supra, was the first case in which the Supreme Court of the United States definitely enunciated the limitation on the rule of inter-governmental exemptions from taxation. In that case the State of South Carolina had taken over, as a state monopoly, the liquor business and advanced the doctrine of McCulloch v. Maryland, as a basis for opposing the payment of federal license taxes. The Supreme Court reviewed the doctrine of inter-governmental instrumentalities, and especially certain of such

decisions which intimated that the doctrine has limits, and said:

> "These decisions, while not controlling the question before us, indicate that the thought has been that the exemption of state agencies and instrumentalities from National taxation is limited to those which are of a strictly governmental character, and does not extend to those which are used by the State in the carrying on of an ordinary private business."
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> 199 U.S. 461.

The court held that the tax must be paid.

Thirty years later the same question was presented to the Supreme Court of the United States in the case of Ohio v. Helvering, 292 U.S. 360 (1934) and the court reached the same result, and said:

> "If a state chooses to go into the business of buying and selling commodities, its right to do so may be conceded so far as the federal Constitution is concerned; but the exercise of the right is not the performance of a governmental function, and must find its support in some authority apart from the police power. When a state enters the market place seeking customers, it divests itself of its quasi sovereignty pro tanto, and takes on the character of a trader, so far, at least, as the taxing power of the federal government is concerned."
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> 292 U.S. 369.

If the argument should be made that the retail liquor business is a purely private and proprietary enterprise, and not for the public welfare, and therefore is entirely different from the public purposes sought to be served by the Federal Reserve System, the case of Helvering v. Powers, 293 U.S. 214 (1934) will be of interest. In that case the question was whether the compensation of the members of the board of trustees of the Boston Elevated Railway Company were constitutionally exempt from federal income taxes. The trustees were appointed by the Governor with the advice and consent of the Council, were obliged to be sworn before entering upon their duties and were charged with the management and operation of the company, and were

given "possession of said properties in behalf of the Commonwealth". Under the act governing the railway, the trustees were to fix fares, and in the event there were any operating deficits, the Commonwealth was to pay them, and for a ten year period there were deficits every year.

The Supreme Judicial Court of Massachusetts had upheld the statute as one enacted for a public purpose and characterized the "public operation" as "undertaken by the Commonwealth, not as a source of profit, but solely for the general welfare". Chief Justice Hughes held that the trustees could not escape the federal income tax, and said:

> "The State cannot withdraw sources of revenue from the federal taxing power by engaging in businesses which constitute a departure from the usual governmental functions and to which, by reason of their nature, the federal taxing power would normally extend. The fact that the State has power to undertake such enterprises, and that they are undertaken for what the State conceives to be the public benefit, does not establish immunity (citing cases). The necessary protection of the independence of the state government is not deemed to go so far."
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> 293 U. S. 225.

> "If the business itself, by reason of its character, is not immune, although undertaken by the State, from a federal excise tax upon its operations, upon what ground can it be said that the compensation of those who conduct the enterprise for the State is exempt from a federal income tax? Their compensation, whether paid out of the returns from the business or otherwise, can have no quality, so far as the federal taxing power is concerned, superior to that of the enterprise in which the compensated service is rendered."
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> 293 U. S. 227.

III.

THE FEDERAL IMMUNITY FROM STATE TAXATION IS MUTUAL AND CO-EXTENSIVE WITH THE STATE IMMUNITY FROM FEDERAL TAXATION.

We have attempted above to show the origin and present status of the doctrine of tax exemption of intergovernmental instrumentalities and to show that a qualification on that doctrine has become as well established as the doctrine itself. In all of the cases which we have discovered, we have found no distinction made between the state's exemption from federal taxation and the federal exemption from state taxation, and many of the cases have specifically stated that they are mutual and have the same scope and extent. Thus, in Indian Motocycle Co. v. U. S., 283 U. S. 570, 577 (1931) the court said "that under the implications of the Constitution the governmental agencies and operations of the states have the same immunity from Federal taxation that like agencies and operations of the United States have from taxation by the states".

In Willcuts v. Bunn, 282 U. S. 216 (1931) the court said "the familiar aphorism is (that as the means and instrumentalities employed by the general government to carry into operation the powers granted to it are exempt from taxation by the states, so are those of the states exempt from taxation by the government'". And in Fox Film Corp. v. Doyal, 286 U. S. 123, 128 (1932), the court said "the principle of the immunity from state taxation of instrumentalities of the Federal Government, and of the corresponding immunity of state instrumentalities from federal taxation - essential to the maintenance of our dual system - has its inherent limitations. It is aimed at the protection of the operations of government. (M'Culloch v. Maryland, 4 Wheat. 316, 436, 4 L.ed. 579, 608), and the immunity does not extend 'to anything lying outside or beyond governmental functions and their exertions.'"

If the immunity of one government from taxation by the other is completely reciprocal, and if, as is established by the cases above, a state instrumentality must exercise an essential governmental function to escape federal taxation, and cannot escape such taxation merely because it is functioning for the general welfare or the public benefit, then the same principle must apply to federal agencies. The case of Railroad Co. v. Peniston, 18 Wall. 5 (1873) involved a state property tax on the assets of a railroad chartered by Congress. The court said:

> "Admitting, then, fully, as we do, that the company is an agent of the General government, designed to be employed, and actually employed, in the legitimate service of the government, both military and postal, does it necessarily follow that its property is exempt from State taxation?"
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> 18 Wall. 32.

The court answered this question in the negative.

To return to the employees of the Federal Reserve Banks, it has been seen that all of the stock in these banks is owned by the member banks, and six of the nine directors of each Federal Reserve Bank are selected by the member banks. The Federal Reserve Banks engage in the business of accepting certain kinds of deposits both from the government and the reserve deposits of the member banks. They discount notes and make private loans, and dividends from profits are paid to the member banks who are stockholders. It is true that the Federal Reserve System was created for a public purpose and that it guides the fiscal and banking policies of the United States Government to a large extent, but its non-governmental functions and dealings would seem sufficient to justify the application of the Missouri income tax laws to its employees. As noted in Flint v. Stone Tracy Co., 220 U. S. 107 (1911):

> "In the case of South Carolina v. United States, 199 U.S. 437, this court held that when a State, acting within its lawful authority, undertook to carry on the liquor business it did not withdraw the agencies of the State carrying on the traffic from the operation of the internal revenue laws of the United States. If a State may not thus withdraw from the operation of a Federal taxing law a subject-matter of such taxation, it is difficult to see how the incorporation of companies whose service, though of a public nature, is, nevertheless, with a view to private profit, can have the effect of denying the Federal right to reach such properties and activities for the purposes of revenue.

> "It is no part of the essential governmental functions of a State to provide means of transportation, supply artificial light, water and the like. These objects are often accomplished through the medium of private corporations, and, though the public may derive a benefit from such operations, the companies carrying on such enterprises are, nevertheless, private companies, whose business is prosecuted for private emolument and advantage. For the purpose of taxation they stand upon the same footing as other private corporations upon which special franchises have been conferred."
> 220 U. S. 172.

The question which you have asked is not free from doubt. A similar question is now pending before the Supreme Court of Missouri in a test case involving the applicability of the Missouri Income Tax Law to an employee of the several units of the United States Farm Credit Administration - State ex rel Baumann v. Bowles, No. 35209 - which will probably be argued before the Court en banc in September of this year. If that case is decided on the merits and is decided in our favor, we believe that its decision would govern the employees of Federal Reserve Banks, and unless that case is decided adversely to us, we are not willing to advise you to exempt employees of the Federal Reserve Banks from Missouri income taxes.

In conclusion, it is our opinion that employees of the Federal Reserve Banks are liable for Missouri income taxes on their income received as compensation from such banks.

Very truly yours,

EDWARD H. MILLER,
Assistant Attorney General.

APPROVED:

J. E. TAYLOR,
(Acting) Attorney General.